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PASS TO USTR BENNETT HARMAN

E.O. 12958: DECL: 03/31/2016
TAGS: [EPET](#) [EINV](#) [ETRD](#) [ECON](#) [PREL](#) [EC](#)
SUBJECT: HYDROCARBON LAW SPELLS TROUBLE FOR EVERYONE

Classified By: Ambassador Linda L. Jewell, Reasons 1.4 (b) and (d)

11. (U) Summary. The Ecuadorian Congress passed a law March 29 that would require private oil companies with participation contracts in Ecuador to share additional revenue with the GOE. If President Palacio signs the law, the GOE could face numerous legal actions because it clearly changes the terms of the current private oil participation contracts. It would also put at great risk GOE prospects for an FTA with the USG. As passed, the law would require oil companies to share 60% of the additional revenues from the difference in the price they currently receive for their Ecuadorian crude oil and what the price of oil was when the contracts took effect in the 1990s. The average Ecuadorian crude oil price when the contracts were negotiated was about \$15. Last year, the average price of Ecuadorian crude was about \$45 a barrel. The Ambassador has forcefully expressed USG concerns about the law to the President, the Foreign Minister and Finance Minister. The best way out for the GOE would be for Palacio to fully veto the law and announce contract renegotiation discussions with the companies. However, it will be difficult for him to do this, since he submitted the original proposal to Congress in the first place. End Summary.

It started with Minister of Economy Diego Borja

12. (U) Minister of Economy Diego Borja first proposed the amendment to the Hydrocarbon law that was submitted to Congress by President Palacio. Borja claimed that the modification of the law signifies the recovery of national sovereignty.⁸ He proposed the law to capture some of the extraordinary earnings⁸ of private oil companies. He told lawmakers that it was their political obligation⁸ to pass the law and said that the revenue generated would be put into a fund for the sectors that were most vulnerable because of the FTA and for health, education and "reactivating production," among other things. Congress passed the law on March 29. The following evening, Borja explained the law to the diplomatic community.

13. (U) The law affects all current participation contracts in the hydrocarbon sector as well as all future contracts. Under the new law, private oil companies must share on a 60/40 basis in favor of the state all oil revenues in excess of the Ecuadorian crude oil price when the contract was enacted and the current crude oil price. For instance, the average oil price when the participation contracts were

entered into in the 1990s was \$15/barrel. In 2005, the average Ecuadorian crude oil price was \$45/barrel. Thus, in the average case, the private oil company would have to give an additional \$18/barrel to the state. There is an inflation price adjustment, based on the U.S. inflation rate. A copy of the law has been sent to WHA/AND.

¶4. (U) Borja told the diplomatic corps March 30 that when the private oil contracts were negotiated or renegotiated in the 1990s the average price for Ecuadorian crude oil was about \$15 a barrel. The parties thus voluntarily entered into the contracts with certain understandings about those economic conditions. He argued that current high Ecuadorian crude oil prices (about \$45 on average in 2005) upset the economic equilibrium that the parties had when the contracts were first negotiated and that equilibrium had to be re-established through reallocation of the participation percentage the state would receive. He argued, absurdly, that requiring the oil companies with participation contracts to share on a 60/40 basis in the state's favor revenues above the Ecuadorian crude oil price at the time of the original contract did not in any way change the terms of the contract, but merely re-established the equilibrium that existed at the time of the contract.

Changes Made By Congress Being Studied

¶5. (U) The law passed by Congress differed from the law proposed by Borja and the Palacio Administration. The Administration wanted a 50/50 split on excess oil revenues. It also expressly excluded marginal field operators from the greater participation requirement. In addition, it also proposed that the law should be enforced retroactively. However, the law passed by Congress includes the 60/40 split and mentions only participation contracts without distinction of whether those would include participation contracts in marginal fields, but does not include a retroactive application provision.

¶6. (U) Borja agreed with another Ambassador at the March 30 meeting that he was concerned about the regulations that would implement the new law because of ambiguities, like the marginal fields issue. The Administration is studying the effects of those changes and what needs to be done to clarify any ambiguity regarding the marginal fields. Borja claims that the companies had a profit margin of 19-23% under the original contract terms. Currently, he claimed the private companies, margin had increased to about 190% on average. Under the new 50/50 version of the Hydrocarbon Law, he said the private companies would still have an 80-90% profit margin. The Administration was studying the changes made by the Congress and would decide its course within the 10 days the Executive has to sign or veto the law, in whole or part. Presidential Advisor Jose Modesto Apolo confirmed in a television interview that a partial veto to exempt marginal fields from the new terms was a possibility, signaling that at least some of the details of the law could still be in play.

Whatever Happened to Negotiations?

¶7. (SBU) The Ambassador asked Borja why the GOE had apparently abandoned its plan to use the French consultants the GOE had hired to analyze current oil contracts and advise the GOE on contract revisions through negotiation. Borja claimed that they had waited seven months and received no response from private oil companies. (Note: The consultants only recently arrived in Ecuador and their report was not due until mid-April. End note.) The Ambassador added that U.S. companies had already stated their willingness to renegotiate their contracts. (Note: Occidental Petroleum has already offered to renegotiate its contract to settle its dispute with the GOE, which has been made very public in the press. End note.) Both Carrion and Borja expressed great surprise at this offer. The Spanish Ambassador commented that a company from his country was also waiting for a

response from the Ministry of Energy regarding renegotiation discussions.

BIT Violation

¶18. (U) Despite Borja,s claims that the new law is legal, the Ambassador noted that other legal experts have said that the new law violates the Ecuadorian Constitution and the U.S.-Ecuadorian Bilateral Investment Treaty (BIT). Borja responded that they had checked with their lawyers and outside consultants who assured them that the law did not violate either the Constitution or any BIT. He reasserted that the law did not change the oil contracts and only changed the economic equilibrium.

Many Opposed to the Law

¶19. (U) The Association of the Hydrocarbon Industry, the Province of Pichincha,s Chamber of Industries, the largest Congressional Block (the Social Christian Party), private oil companies, legal scholars and others oppose the law. Collectively, they have alleged that the law violates some eight different provisions of the Ecuadorian Constitution, a number of Bilateral Investment Treaties (BIT) and several provisions of Ecuadorian law. Constitutional scholar Hernan Perez Loose wrote that when Argentina passed a similar law it faced 40 international legal actions and ended up paying \$17 million. Occidental Petroleum (Oxy) said that if the law is enacted Oxy would withdraw its \$1 billion plus offer to settle its pending dispute with the GOE.

¶10. (SBU) USTR considered suspending the FTA negotiations. Several European nations expressed their concern to the Ecuadorian Congress and President Palacio.
Law Punishes Most Productive Segment of the Sector

¶11. (U) Private oil companies, with about 25% of proven reserves, account for over 60% of total oil production in Ecuador. According to industry sources, the new law also fails to consider the fact that some of the new wells conceived and in production were marginal prospects that were developed because of the high price environment. Changing the economic conditions of the contracts might make such projects less economically viable. Therefore, the law could have the perverse effect of reducing oil production.

¶12. (SBU) State-owned oil company PetroEcuador,s production has been on a general decline for a decade. Its notorious inefficiency and corruption are reportedly responsible for hundreds of millions of dollars in lost revenue to the state on an annual basis. The industry regulator, the National Directorate of Hydrocarbons (DNH) allegedly arbitrarily refuses to grant production permits, requiring at least one company to shut-in production of about 10,000 barrels a day, costing the company and the GOE hundreds of thousands of dollars in lost revenue each day. Thus, many argue the GOE should focus on the state-controlled segment of the oil sector if it wants to achieve constant and sustainable new revenue.

Palacio Convinced on Law

¶13. (C) The Ambassador spoke with President Palacio on March 31. He took Diego Borja's argument hook, line and sinker that the new law did not change the current contracts. He also does not think it violates our BIT. Palacio said that he is willing to negotiate with the oil companies individually, but said that the new law could form the basis for those discussions. The Ambassador explained that it was our view that the proposed law, if passed, would violate the BIT and put at great risk Ecuador's FTA with the USG. She suggested that he could use the changes made by the Congress as an excuse to fully veto the bill and gather the private oil companies together to publicly announce that they would

begin negotiations and thereby accomplish the purpose of the law, without risk of legal actions. Palacio responded that such a course would be politically difficult, but he did not reject it as impossible.

¶14. (C) After the Ambassador spoke with Palacio, she spoke with Ecuador's Ambassador to Washington, Luis Gallegos, and explained the same plan to him. Gallegos said that he and Trade Minister Illingworth were extremely frustrated about the proposed hydrocarbon law. They did not believe the outside legal advice that they had been given that the law did not violate the Ecuadorian Constitution or international agreements, such as BITs. Gallegos said that he would talk to Foreign Minister Carrion to have him tell Palacio about the negative international implications, should the Palacio sign the bill into law.

Comment

¶15. (SBU) Again, the GOE has boxed itself into a corner. It proposed a law that was opposed even by its own Ministry of Energy and PetroEcuador. In the quest for quick revenue, it ignored the legal challenges that it should have known it would face. Congress passed a different version of the law than that first proposed by the Administration. This would give Palacio the opportunity to veto the law and allow the GOE and the private companies to negotiate contract revisions, even though the bill came from Palacio.

¶16. (C) There is a chance that Palacio might be convinced to take advantage of the changes made by the Congress and veto the law. We are hopeful that interventions by the Ambassador, Carrion, Illingworth and others can sway Palacio, but that is by no means assured. Palacio still does not understand how this proposed law violates current oil contracts with private companies, but he is very concerned about the controversy the law has stirred. Both sides could declare victory, if Palacio were to veto the law while extracting a very public commitment from the oil companies to start contract renegotiation discussions. The GOE would likely get a larger share of oil revenues and the private companies will be able to negotiate new terms based on the economics of their individual blocks. It could also resurrect the Oxy settlement offer. If the GOE was wise, it could take credit for resolving that issue too; though, the Administration would also receive more than its share of criticism from anti-Oxy groups.

¶17. (C) It is also very possible that Borja would leave the GOE if that were to occur, and he has otherwise been a responsible Minister of Economy, holding down spending in an election year as best he could. Borja is the third Economy Minister in Palacio's first year in office. The Administration could probably weather yet another change of ministers. Besides, it was Borja's proposal (and Palacio's support of it) that created this latest fiasco for the Administration.

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